

Cambridge IGCSE · Economics 0455 · Notes

Foreign exchange rates

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Read first: [Price determination](#), [Price elasticity of demand \(PED\)](#), [Monetary policy](#)

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What you need to know

This topic has five syllabus outcomes:

1. **What a foreign exchange rate is**, and what **floating** and **fixed** exchange rate systems are.
2. **How the exchange rate is set in the foreign exchange market**: the demand for and supply of a currency, and the **equilibrium** exchange rate where they meet.
3. **Why exchange rates change**: shifts in demand for exports and imports, changes in the **rate of interest**, **speculation**, and multinational companies (**MNCs**) arriving in or leaving a country.
4. **What a change in the exchange rate does**: to the prices of exports and imports, and, through **price elasticity of demand (PED)**, to how much is spent on exports and imports.
5. **Floating versus fixed**: how the two systems differ, and the advantages and disadvantages of each.

The current account of the balance of payments has its own topic; here you need only the link from the exchange rate to export revenue and import spending. How a central bank sets interest rates is monetary policy.

Understand it

What an exchange rate is

A **foreign exchange rate** is **the price of one currency in terms of another**. If 1 peso = \$0.50, a peso costs half a US dollar; turned round, \$1 = 2 pesos. Both lines say the same thing.

Anyone buying from abroad needs the seller's currency, so they sell their own currency for it in the **foreign exchange market**.

A currency's **external value** is its exchange rate. Don't mix it up with its **internal value**, which is how much it buys at home and falls when there is inflation.

Words for a change in the rate:

The currency...	Floating system (market forces)	Fixed system (the government decides)
rises in value	appreciation	revaluation
falls in value	depreciation	devaluation

A currency is called **strong** when its exchange rate is high or rising and **weak** when it is low or falling.

Comparing prices in different countries needs exchange rates: a bus ticket costing 90 rupees and one costing 4 euros can only be compared once both prices are in the same currency.

Converting prices

To find what a good costs a foreign buyer, convert its home price at the exchange rate.

- A shirt made in the country sells for 40 pesos. At 1 peso = \$0.50 an American pays $40 \times 0.50 = 20$ dollars.
- If the peso **appreciates** to \$0.70, the same shirt costs $40 \times 0.70 = 28$ dollars: **dearer** for foreigners.
- If the peso **depreciates** to \$0.30, it costs $40 \times 0.30 = 12$ dollars: **cheaper** for foreigners.

Imports work the other way. An American machine priced at \$600 costs $600 \div 0.50 = 1\,200$ pesos at \$0.50, but only $600 \div 0.70 \approx 857$ pesos after an appreciation to \$0.70, and $600 \div 0.30 = 2\,000$ pesos after a depreciation to \$0.30.

Remember it as **SPICED**: a **S**trong **P**eso makes **I**mports **C**heaper and **E**xports **D**earer. A weak currency does the opposite: exports cheaper, imports dearer.

Demand for and supply of a currency

Think of the peso as a product, with its price (in dollars) on the vertical axis and the quantity of pesos on the horizontal axis.

Demand for pesos comes from people who hold other currencies and need pesos:

- foreigners buying the country's **exports** of goods and services, including **tourists** visiting the country;
- foreign firms **investing** in the country, such as an MNC building a factory there (foreign direct investment, **FDI**);
- savers abroad putting money in the country's banks to earn its **interest rate** (called **hot money**);
- **speculators** who expect the peso to rise and want to sell it later at a profit;
- the country's workers abroad sending money home (**remittances**);
- the country's **central bank** buying its own currency.

Supply of pesos comes from people who hold pesos and want other currencies. They supply pesos to buy:

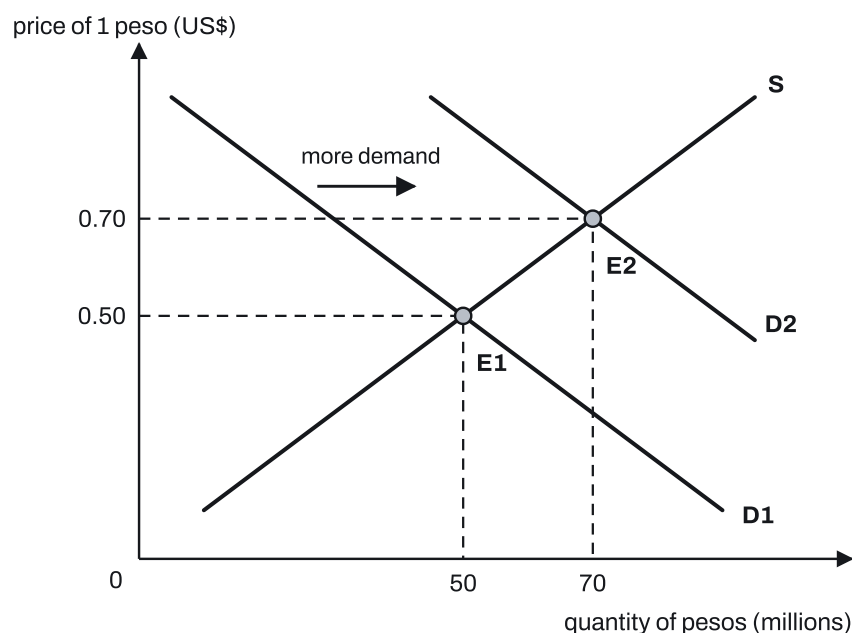
- **imports** of goods and services, including the country's residents holidaying abroad;
- assets abroad: firms from the country investing abroad, or savers moving money to countries with higher interest rates;
- foreign currency because they expect the peso to fall (speculation);

- MNCs sending their profits home, or leaving the country;
- the central bank selling pesos.

The demand curve slopes down and the supply curve slopes up, as in any market. In a **floating** system, the exchange rate settles where the quantity of pesos demanded equals the quantity supplied: the **equilibrium exchange rate**. In the diagrams below, demand is $Q_d = 100 - 100P$ and supply is $Q_s = 100P$ (in millions of pesos, with P in dollars), so the equilibrium is 1 peso = \$0.50, with 50 million pesos traded.

Why exchange rates change

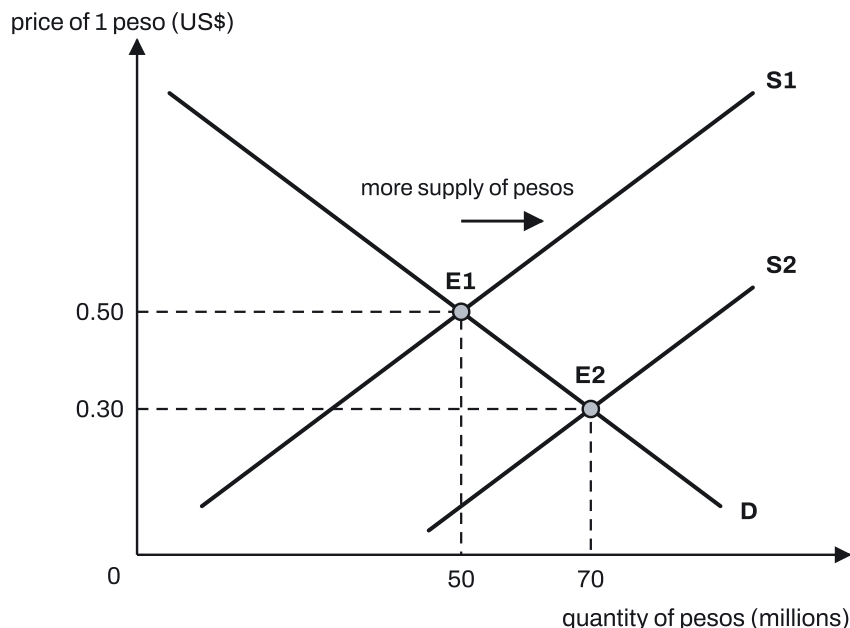
A floating exchange rate moves whenever demand for or supply of the currency shifts.



Demand for the currency rises (curve shifts right), so it **appreciates**, when:

- **exports rise**: foreign incomes grow, the country's goods become better quality or relatively cheaper (lower inflation than its trading partners), or trade barriers abroad are removed; more foreign tourists come;
- **the country's interest rate rises** (or interest rates abroad fall): saving there pays more, so hot money flows in;
- **MNCs enter** the country or other FDI flows in;
- **speculators** expect the currency to rise and buy it now;
- remittances from workers abroad rise, or the central bank buys the currency.

In the first diagram, extra demand of 40 million pesos at every price ($Q_d = 140 - 100P$) raises the rate from \$0.50 to \$0.70, and 70 million pesos are traded.



Supply of the currency rises (curve shifts right), so it **depreciates**, when:

- **imports rise**: higher incomes at home, home inflation above other countries' so foreign goods look cheaper, or tariffs removed; more residents holiday abroad;
- **interest rates abroad rise** (or the country's own rate falls): savers move money out;
- firms invest abroad, or **MNCs leave** and take their money home;
- **speculators** expect a fall and sell the currency;
- the central bank sells its currency.

In the second diagram, extra supply of 40 million pesos at every price ($Q_s = 100P + 40$) lowers the rate from \$0.50 to \$0.30, again with 70 million pesos traded.

A fall in demand for the currency (fewer exports, fewer tourists, a lower interest rate, MNCs leaving) shifts demand **left** and also causes a depreciation; a fall in supply (fewer imports) shifts supply left and causes an appreciation. One event can shift **both** curves: when a country exports more and imports less, demand for its currency rises and supply falls, so its rate **definitely** rises, but the quantity traded could go either way.

PED matters here too. Suppose a country's copper is paid for in its own currency and world demand for copper is price inelastic. If the copper price falls, buyers buy only a little more, so total spending on copper falls, buyers need less of the currency, demand for it falls and its exchange rate falls.

How a government or central bank can stop its currency falling: raise the interest rate (attracting hot money and raising demand for the currency), or buy its own currency with its **reserves** of foreign currency. To push it down, it does the opposite: cuts the interest rate or sells its currency.

What a change in the exchange rate does

The **direct** effect is on prices, as in "Converting prices":

	Export prices (in foreign currency)	Import prices (in home currency)
Depreciation (or devaluation)	fall: exports more price competitive	rise
Appreciation (or revaluation)	rise: exports less competitive	fall

What happens to **spending** then depends on **price elasticity of demand**.

Exports. After a depreciation, the price foreigners pay falls. If foreign demand for the exports is **price elastic**, the quantity bought rises by a bigger percentage than the price fell, so **export revenue rises**. Example: a coffee exporter sells at 1 000 pesos a bag. When the peso falls from \$0.50 to \$0.40, the dollar price falls from \$500 to \$400, a fall of 20%. With a PED of -2 , the quantity sold rises by 40%. Revenue in pesos rises by 40% (each bag still earns 1 000 pesos); even in dollars it rises, because $0.8 \times 1.4 = 1.12$, a rise of 12%. If foreign demand is **price inelastic**, the quantity rises only a little and revenue in foreign currency falls.

Imports. After a depreciation, imports cost more in pesos. If demand for imports is **price elastic**, buyers switch to home-produced goods and **spending on imports falls**. If it is **inelastic** (oil, medicines, machines with no home-made substitute), people keep buying, and spending on imports can **rise**. Example: the \$600 machine rises from 1 200 to 1 500 pesos when the peso falls to \$0.40, a rise of 25%. With a PED of -0.5 the quantity bought falls by only 12.5%, so spending in pesos rises by $1.25 \times 0.875 = 1.09375$, about 9.4%.

So a depreciation **improves the current account** (exports up, imports down) only if demand for exports and imports is elastic enough. It also takes time: contracts are signed in advance and buyers take a while to switch, so the current account can get worse before it gets better.

The knock-on effects of a **depreciation**:

- **Current account:** more export revenue and less import spending reduce a deficit (if demand is elastic).
- **Output, growth and jobs:** export firms sell more abroad, and home firms sell more at home as buyers switch away from dearer imports. They produce more and hire more workers, so **unemployment falls** and **total demand** and **economic growth** rise. Tourism grows, because holidays in the country become cheaper for foreigners.
- **Inflation rises:** imported **raw materials**, components and fuel cost more, raising firms' costs (**cost-push inflation**); imported consumer goods cost more; higher demand for exports and home goods adds **demand-pull inflation**; and home firms face less competition from imports, so they feel less pressure to keep prices low.
- **Living standards:** people's money buys fewer imports, so their **purchasing power** falls.
- **Investment:** foreign assets in the country become cheaper, which can attract MNCs; but a falling currency can also damage **confidence**, and debts owed in foreign currency become dearer to repay.

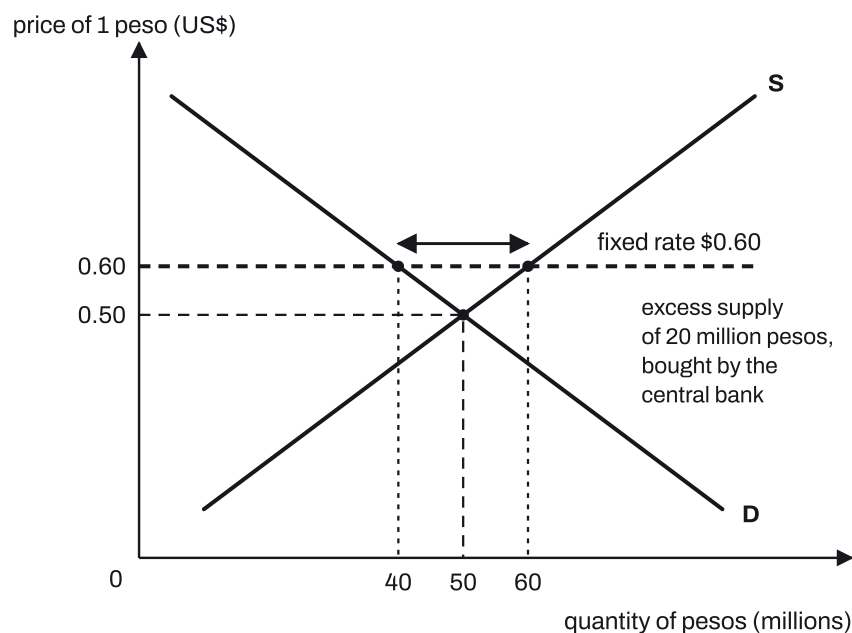
The knock-on effects of an **appreciation** are the reverse: cheaper imports and imported raw materials cut costs and **inflation**, and home firms must keep prices down to compete; consumers' **purchasing power** rises; but exports cost more abroad, so (with elastic demand) export firms and firms competing with imports sell less, cut output and jobs, **unemployment can rise** and the **current account worsens**.

Who gains depends on the side of the trade: an appreciation helps buyers of foreign goods (importers, consumers, firms using imported inputs) and hurts sellers to foreigners (exporters, tourism, firms competing with imports).

Fixed and floating systems

In a **floating exchange rate system**, the rate is set by **market forces**, the demand for and supply of the currency, and changes whenever they change. The government does not aim at any particular rate.

In a **fixed exchange rate system**, the **government or central bank** sets the rate, often against one major currency such as the US dollar, and keeps it there by **intervening** in the foreign exchange market.



Keeping the rate fixed. If the rate is fixed **above** the equilibrium (\$0.60 in the diagram), more pesos are supplied (60 million) than demanded (40 million). Left alone, the rate would fall. To hold it, the central bank must **buy** the excess supply of 20 million pesos, paying with its **reserves of foreign currency** (here $20 \times 0.60 = 12$ million dollars), or raise interest rates to increase demand for pesos. If the rate is fixed **below** equilibrium, there is excess demand, and the central bank **sells** its currency (adding to its reserves) or cuts interest rates. So running a fixed rate needs **reserves of foreign currency**, and the interest rate must often be used to defend the rate.

A fixed rate is not fixed for ever: the government can **devalue** it (set it lower) or **revalue** it (set it higher).

Advantages of a fixed exchange rate:

- **Certainty:** firms know what they will pay for imports and earn from exports, so they can plan; trade is less risky.
- **More investment:** MNCs and other foreign investors are more confident when the value of their investment and profits will not be cut by a currency fall.
- **Discipline on inflation:** firms cannot rely on a falling currency to keep exports competitive, so they must control costs; the government must keep inflation down.

- **Can be set low** to make exports competitive, or **devalued** to correct a current account deficit.

Disadvantages of a fixed exchange rate:

- The central bank needs **large reserves** of foreign currency, which have an opportunity cost, and may run out.
- **Monetary policy is tied up**: interest rates must be set to defend the rate, not to fight unemployment or inflation, so other macroeconomic aims can suffer (for example, a rise in interest rates to stop the currency falling can cause unemployment).
- The rate may be set **at the wrong level: too high**, exports are uncompetitive, imports cheap, so the current account worsens and jobs are lost; **too low**, imports are dear, causing inflation.
- It **does not adjust automatically** to correct a current account deficit.
- If **inflation at home** is higher than abroad, exports become steadily less competitive at the same rate.

Advantages of a floating exchange rate:

- It **can correct a current account imbalance automatically**: a deficit means import spending exceeds export revenue, so more of the currency is supplied than demanded and it depreciates; exports become cheaper and imports dearer, which reduces the deficit (if demand is elastic). A surplus makes it appreciate, which reduces the surplus.
- **No reserves** are needed to hold the rate.
- The **interest rate is free** for other aims, such as controlling inflation or reducing unemployment.
- It reflects market conditions, so the currency is not stuck at the wrong level.

Disadvantages of a floating exchange rate:

- **Uncertainty**: the rate can change a lot, so firms do not know what they will pay for imports or earn from exports, which makes planning hard and trade riskier.
- **Less investment**: foreign investors may hold back, not knowing what their assets and profits will be worth.
- **Speculation** can cause large, destabilising swings that have nothing to do with trade.
- A fall can cause **imported inflation**; a rise can hurt exporters and jobs.

Key facts and formulas

There is no formula list for 0455. "Learn it" means you must remember it.

Formula or fact	Status
Foreign exchange rate: the price of one currency in terms of another currency	Learn it
Floating system: the rate is set by the demand for and supply of the currency; fixed system: the government or central bank sets the rate and holds it by intervening	Learn it

Formula or fact	Status
Floating: rise = appreciation, fall = depreciation. Fixed: rise = revaluation, fall = devaluation	Learn it
Price abroad = home price $\times$ exchange rate (foreign currency per unit of home currency)	Learn it
Home price of an import = foreign price $\div$ exchange rate (foreign currency per unit of home currency)	Learn it
If 1 unit of home currency = r units of foreign currency, then 1 unit of foreign currency = $\frac{1}{r}$ units of home currency	Learn it
Percentage change in the exchange rate = $\frac{\text{new rate} - \text{old rate}}{\text{old rate}} \times 100$	Learn it
Demand for a currency: its exports, inward investment and FDI, hot money, speculation, remittances, central bank buying	Learn it
Supply of a currency: its imports, investment abroad, money leaving for higher interest rates abroad, speculation, central bank selling	Learn it
Depreciation: export prices fall, import prices rise. Appreciation: export prices rise, import prices fall	Learn it
Spending on exports and imports moves the "right" way after a depreciation only if their demand is price elastic	Learn it
Excess supply at a fixed rate is bought by the central bank with its foreign currency reserves	Learn it

How to do it

We have tagged 56 questions on this topic (2021–2026): 35 multiple choice on Paper 1 (three of them repeats on another variant) and 21 structured questions on Paper 2, counting only the parts about this topic. No question has parts of two exchange-rate types, so the counts add up to 56.

Question type	Questions
Explain the consequences of an appreciation or depreciation	16
Explain causes of a change in the exchange rate	15
Discuss whether a rise or fall in the exchange rate benefits or harms an economy	6
Discuss whether a fixed or a floating exchange rate system benefits an economy	4
Identify features of, and differences between, fixed and floating systems	4
Define the exchange rate and its terms	4
Read a foreign exchange market diagram	3

Question type	Questions
Calculate a price in another currency after the rate changes	3
Analyse data linking the exchange rate to another variable	1

Written answers: plan **point** → **developed chain of reasoning** (→ **a diagram where it helps**) → **for Discuss, the other side with new reasons** → **a judgement**. Define or Identify (2 marks) needs two short items or the two halves of a definition; Explain (4 marks) needs **two** points, each identified (1) and explained (1); Analyse (6 marks) needs about **three** developed chains, each link a mark; Discuss needs at least two developed points on each side and a judgement saying what the answer depends on.

1. Explain the consequences of an appreciation or depreciation (16 questions)

Multiple choice (11): decide first whether the currency has risen or fallen, then use the table in "What a change in the exchange rate does".

- Read the rate carefully: if one unit of the home currency now buys **fewer** units of the foreign currency, it has **fallen**. The first thing a fall changes is prices: **import prices rise** at home, and exports cost less abroad, so they become **more competitive**. Effects on output, jobs and inflation come later, through quantities; over time, with elastic demand, a fall tends to shrink a current account deficit.
- A fall makes everything the country sells abroad, goods and tourism alike, **cheaper for foreign buyers**, so it raises **foreign demand for the country's products**. That is why a devaluation is the exchange-rate tool for raising exports and, as firms produce more, cutting unemployment.
- To find who **gains from a rise**, look for those who **pay** in foreign currency: importers, buyers of imported goods and firms using imported inputs, whose costs fall. Those who **earn** foreign currency (exporters, tourism) or compete with imports at home lose.

Written questions (5): "Analyse how a fall in the exchange rate could reduce a current account deficit / increase employment / increase inflation", or "how a rise could reduce inflation" (6 marks). Build **one-way chains**, one mark a link, ending at the aim in the question:

- **Current account deficit:** fall in the rate → export prices fall abroad → (with elastic demand) more exports sold → **export revenue rises**; import prices rise at home → people switch to home goods → **import spending falls**; so the gap between import spending and export revenue narrows. Mention PED: if demand is inelastic, spending may move the wrong way.
- **Employment:** exports cheaper → more sold → export firms raise output → **hire more workers**; imports dearer → demand switches to home producers → they expand and hire; more output and incomes → higher total demand → more jobs elsewhere; tourism rises.
- **Inflation up:** imports dearer → imported raw materials and fuel cost more → firms' **costs rise** → **cost-push inflation**; imported consumer goods dearer → the price level rises directly; more exports and home demand → total demand rises → **demand-pull inflation**; less competition from imports → home firms can raise prices.

- **Inflation down** (after a rise): imports cheaper → cheaper raw materials → lower costs → less cost-push inflation; imported consumer goods cheaper; exports dearer, so fewer sold → lower total demand → less demand-pull inflation; home firms face cheaper imports, so they must keep prices down and cut costs.

2. Explain causes of a change in the exchange rate (15 questions)

Multiple choice (11): use the lists in "Why exchange rates change". Ask: does this event make people want **more of the currency** (demand right, the rate rises) or **sell more of it** (supply right, the rate falls)?

- More **exports** (of goods or services) raise demand for the currency; a rise in the country's **exports of services** shifts demand right.
- More **foreign direct investment into** a country raises demand for its currency; **less** FDI into it shifts demand left.
- A **fall in a country's interest rates** cuts demand for its currency, because less hot money flows in.
- More **imports** mean more of the currency supplied: when its people demand more imports, supply shifts right and the rate falls.
- Combinations: the rate **definitely rises** when demand for the country's exports **rises** and its demand for imports **falls**; it **depreciates** when export revenue **falls** and import spending **rises**.
- To **stop a fall**, a central bank **raises interest rates** or buys its own currency with its reserves.
- With PED: if a good paid for in a currency gets cheaper and demand for it is inelastic, total spending on it falls, so there is **less demand for that currency** and its rate falls.

Written questions (4):

1. **"Explain two causes of a rise (or fall) in a floating exchange rate"** (4): for each, name the cause (1) and say whether it shifts demand or supply and which way (1). For example, "a rise in the country's interest rate (1) attracts hot money from savers abroad, who must buy the currency, so demand for it rises (1)".
2. **"Analyse the causes of a fall (or rise) in the exchange rate"** (6): several causes, each with its chain. For a **fall**: the government **devalues** a fixed rate to correct a deficit; the central bank cuts the interest rate or sells the currency; **supply rises** (more imports, more investment abroad, higher interest rates abroad, speculators expecting a fall, MNCs leaving); **demand falls** (fewer exports, a lower interest rate, fewer remittances from workers abroad).
3. **"Analyse the causes of an increase in the demand for a foreign currency"** (6): turn the lists round: people in the country want **another** currency to buy that country's goods and services (higher incomes at home, higher inflation at home, better quality abroad, trade barriers removed, more holidays there), to **invest** there (FDI, an MNC setting up a branch), to take advantage of **higher interest rates** there (hot money), to **speculate** that it will rise, to send money to relatives or buy property there, or the central bank buys it for its reserves.

3. Discuss whether a rise or fall in the exchange rate benefits or harms an economy (6 questions)

All Paper 2: Section A (6 marks, up to 4 for each side) or Section B (8 marks, levels). Use the two lists of knock-on effects in "What a change in the exchange rate does". **Write the price effect first** and check its direction.

Change	Benefits	Harms
Fall in the rate	exports cheaper → more sold → export revenue, output, growth and jobs rise; buyers switch from imports to home goods; current account deficit shrinks; tourism grows; cheaper assets attract MNCs and FDI	imports and imported raw materials dearer → cost-push inflation; lower purchasing power and living standards; less pressure on home firms to keep prices low and quality high; lower confidence and investment; foreign debts dearer
Rise in the rate	imports and raw materials cheaper → lower costs, less inflation; higher purchasing power for consumers; firms must become more efficient to compete	exports dearer → fewer sold → export firms cut output and jobs; buyers switch to imports, so home firms lose sales; current account worsens; tourism falls

Variant: "Should a government try to stop its exchange rate falling?" The "should stop it" side is the harms of a fall; the "should let it fall" side is the benefits of a fall **plus the cost of intervening**: raising interest rates hurts borrowing, investment and jobs, and buying the currency uses up reserves, which have an opportunity cost (that money could pay for education, healthcare or housing).

Judgement: it depends on the PED for exports and imports, how much the country relies on imported raw materials, whether the economy has spare capacity to produce more, how big and how lasting the change is, and which aim matters most now (inflation or unemployment).

4. Discuss whether a fixed or a floating exchange rate system benefits an economy (4 questions)

Discuss the **system**, not just whether a strong or weak currency is good. Use the four lists in "Fixed and floating systems".

- For a question on **fixed** rates, develop two advantages and two disadvantages from the fixed lists; for **floating**, use the floating lists. Comparing with the other system helps, but each side needs its own reasons.
- The strongest floating point is the automatic correction of a current account imbalance: explain the whole chain (deficit → excess supply of the currency → depreciation → exports cheaper, imports dearer → deficit narrows).
- For each point, add **why it matters**: "certainty" alone is Level 1; "firms know the price of their imported raw materials, so they can plan output and invest" is developed.

- **Judgement:** a small economy that trades mainly with one large partner may benefit from fixing to its currency; a country with a large deficit, or one needing interest rates to control inflation, may be better floating. It depends on the level the rate is fixed at and the size of the reserves.

5. Identify features of, and differences between, fixed and floating systems (4 questions)

Multiple choice: a rate set by the **forces of demand and supply** is a **floating** system. A **fixed** system needs **reserves of foreign currencies** to defend the rate. An advantage of floating is that it **can correct a current account deficit or surplus** on its own.

"Explain two differences" (4): give each difference **from both sides** in one point (1), then explain it (1):

1. **Who sets it:** a floating rate is set by market forces, a fixed rate by the government or central bank (1); so a floating rate changes whenever demand or supply of the currency changes, while a fixed rate changes only when the government decides (1).
2. **Names for changes:** a floating rate appreciates or depreciates, a fixed rate is revalued or devalued (1).
3. **Reserves and intervention:** a fixed rate needs reserves of foreign currency and intervention to hold it, a floating rate needs neither (1); for example, the central bank must buy its currency when there is excess supply (1).
4. **Interest rates:** with a fixed rate, the interest rate is used to keep the rate in place; with a floating rate it can be used for other aims (1).

A "mirror image" ("a floating rate is not fixed but a fixed rate does not change") earns nothing, and a fixed rate **can** change.

6. Define the exchange rate and its terms (4 questions)

- **Foreign exchange rate:** the price of one currency (1) in terms of another currency (1). Any exchange rate measures **the cost of one currency in units of another**, for example how many rupees one euro costs.
- A cut in the value of a currency in a **fixed** system is a **devaluation**; a rise is a **revaluation**. In a floating system the words are depreciation and appreciation.
- To compare a good's price across countries using different currencies, you need the **exchange rates**.

7. Read a foreign exchange market diagram (3 questions)

Multiple choice with a currency market diagram and several possible new equilibrium points.

1. Name the currency on the axes (the price of the US\$, or of the Singapore dollar, and so on).
2. For each event, decide which curve shifts and which way, using "Why exchange rates change". The country that **imports more** supplies more of **its own** currency: supply shifts right and the new equilibrium lies at a **lower price and a higher quantity** on the same demand curve.
3. If an event shifts **both** curves (exports up and imports down: demand right, supply left), the price **rises** for sure; pick the point above the original on the new demand curve and the new supply curve.

4. **Fixed rate above equilibrium:** at the fixed price, find the quantity demanded and the quantity supplied. The gap between them is the **excess supply**, which the central bank must **buy**. (Below equilibrium there is excess demand, which it must **sell**.) In the third diagram, at \$0.60 the central bank buys 20 million pesos (from 40 to 60 on the quantity axis).

8. Calculate a price in another currency after the rate changes (3 questions)

1. Find the good's price in the **seller's** currency, which usually stays the same.
2. Convert at the **new** rate.

For example, a good priced at \$30 in the US when 4 pesos = \$1 costs $30 \times 4 = 120$ pesos at home. If the rate moves to 6 pesos = \$1, it sells in the US for $120 \div 6 = 20$ dollars: more pesos per dollar means the peso is **weaker**, so the export is **cheaper** abroad.

A percentage change in strength: if the home currency **strengthens** by 20%, each unit buys 20% more foreign currency, so an import with an unchanged foreign price costs **less** at home: divide by 1.2. An import that cost 6 000 pesos now costs $6\,000 \div 1.2 = 5\,000$ pesos. A stronger currency lowers the home price of imports; a weaker one raises it.

9. Analyse data linking the exchange rate to another variable (1 question)

Section A data question (5 marks), for example a currency's value against world economic growth.

1. **State the expected relationship** and its direction (positive or inverse) (1), with what it means (1).
2. **Give evidence** from the data: a period where both moved as expected (1 each).
3. **Explain why**, using this topic: in uncertain times investors move money into a "safe" currency, so demand for it rises and it appreciates when world growth falls; or higher prices of an export raise export revenue and demand for the currency.
4. **Name an exception** (a year that breaks the pattern) and give a reason: other things also move exchange rates (interest rates, inflation, speculation, a pandemic).

Worked examples

Example 1

The exchange rate of the peso changes from 1 peso = \$0.25 to 1 peso = \$0.20.

- (a) Define **foreign exchange rate**. [2]
- (b) Calculate the percentage change in the value of the peso against the US dollar, and state what this change is called if the peso is floating. [2]
- (c) A jacket made in the country sells for 200 pesos. Calculate its price in US dollars before and after the change. [2]

(d) Explain **two** causes of this change in the exchange rate. [4]

(a) The price of one currency (1) expressed in terms of another currency (1).

(b) $\frac{0.20 - 0.25}{0.25} \times 100 = -20\%$, a fall of 20% (1). In a floating system this is a **depreciation** (1).

(c) Before: $200 \times 0.25 = 50$ dollars (1); after: $200 \times 0.20 = 40$ dollars (1).

(d) A fall in the country's interest rate (1) makes saving there less rewarding, so savers abroad move their money out, demand for the peso falls and its price falls (1).

People in the country buying more imports (1) must sell pesos to buy foreign currency to pay for them, so the supply of pesos increases and its price falls (1).

Example 2

Analyse how a rise in a country's foreign exchange rate could increase its unemployment. [6]

A rise in the exchange rate makes the country's exports more expensive in foreign currencies (1). If foreign demand for them is price elastic, foreign buyers buy noticeably fewer (1), so export firms' sales and revenue fall (1) and they cut output and need fewer workers (1). Imports become cheaper in the home currency (1), so consumers switch from home-produced goods to imports (1), and firms competing with imports lose sales and make workers redundant (1). Foreign tourists find holidays in the country dearer, so tourism jobs are lost (1). The workers who lose their jobs have less income to spend, so total demand falls further and other firms cut jobs too (1). (Any 6.)

Example 3

A country has a fixed exchange rate and a large deficit on the current account of its balance of payments.

Discuss whether or not its government should devalue the currency to reduce the deficit. [8]

A devaluation is a cut in the value of a currency in a fixed exchange rate system, set by the government. A current account deficit means spending on imports (and other payments abroad) is greater than export revenue.

Why it should. After a devaluation, the country's exports cost less in foreign currencies. If foreign demand is price elastic, many more are sold and export revenue rises. Import prices rise at home, so people buy home-produced substitutes instead, and spending on imports falls. Both narrow the deficit (developed point for).

Export firms and firms competing with imports raise their output and hire more workers, so unemployment falls and economic growth rises; tourism also grows as the country becomes a cheaper place to visit (developed point for).

Why it should not. If demand for exports and imports is price inelastic, as for imported oil and machinery with no home-made substitute, spending on imports may rise and export revenue may hardly change, so the deficit could get worse. Contracts are agreed in advance, so even with elastic demand it takes time to work

(developed point against).

Dearer imported raw materials and fuel raise firms' costs, causing cost-push inflation. As home prices rise, exports lose their price advantage, so the gain may only be temporary; and with weaker competition from imports, home firms have less reason to cut costs (developed point against).

Judgement. A devaluation is more likely to reduce the deficit if demand for exports and imports is price elastic, the country has spare capacity to produce more, and inflation is kept under control afterwards. If the deficit comes from poor quality or high costs, supply-side policies that make firms more competitive may work better in the long run. Both sides are developed and the judgement says what it depends on: Level 3 (6–8 marks).

Common mistakes

- **Getting the direction wrong.** The most common error every year (November 2021, November 2022, June 2022, June 2023, and the November 2025 mark scheme warns of it): saying a rise in the exchange rate makes exports **cheaper**, or writing about the opposite change to the one asked. A rise makes exports **dearer** and imports **cheaper**. Write the price line first.
- **Confusing internal and external value.** June 2022: many wrote about a fall in what money buys at home (inflation) when the question was about a depreciation of the exchange rate.
- **Saying "imported inflation" and stopping.** November 2022: say **why**: dearer imported raw materials raise costs (cost-push), dearer consumer imports raise the price level, more exports raise total demand (demand-pull).
- **Forgetting PED.** June 2023: an appreciation reduces export revenue only if demand for exports is elastic. Mention elasticity when spending on exports or imports is in the question.
- **Thinking export revenue goes to the government.** November 2021: export revenue goes to the **firms** that export, not to the government.
- **Mirror-image differences and "fixed rates never change".** November 2021: "floating rates aren't fixed, fixed rates don't change" earns little. Give two separate differences (who sets it, reserves, the words for a change), and remember a fixed rate can be devalued or revalued.
- **Answering a different question about the system.** June 2025: answers on whether a **floating system** benefits an economy wrote only about strong and weak currencies; the best used the automatic correction of a current account imbalance and the uncertainty for trade and investment. March 2026: answers on a fixed rate made one-line statements ("fixed rates don't change"), or drifted into MNCs.
- **Turning another question into an exchange-rate one.** March 2022 and March 2025: answers on interest rates or the money supply drifted into the pros and cons of a higher or lower exchange rate. Use the exchange rate only as one link in the chain the question asks for.
- **Ignoring the level of a fixed rate.** November 2022: the best answers said whether the rate was fixed **too high** (lost exports and jobs) or **too low** (inflation).
- **Calculating the wrong way.** June 2021: when a currency strengthened, some worked out a **higher** home price for an import, as if it had weakened.

How to get the marks

- **Define** (2 marks): both halves: "the price of one currency" (1) "in terms of another" (1).
- **Identify** (2 marks): two short items; if you write more, only the first three are considered.
- **Explain** (4 marks): two points, each named (1) and developed (1). For a cause, say which curve shifts and which way; for a consequence, say what happens to prices and then to quantities.
- **Analyse** (6 marks): chains of linked steps, one side only; each correct link is a mark, and repeating an idea scores once. End each chain at the aim in the question (inflation, jobs, the current account).
- **Discuss** (6 marks, Section A): up to 4 marks a side, at most 3 without development. Turning a point round ("exports may rise" then "exports may not rise") earns nothing; the other side needs a **new** reason.
- **Discuss** (8 marks, Section B): Level 3 (6–8) needs both sides developed and a judgement; Level 2 (3–5) is one-sided or thin; Level 1 (1–2) is definitions only. Define the key term, write two developed points a side, then say what the answer depends on (PED, reserves, the level of the rate, spare capacity, inflation).
- **Use the source** in Section A: name the country, its currency and the facts given (a fall in the rate, a tourism industry, imported fuel), and add your own reasons.
- **Calculations**: show the working and the units (\$, pesos); for a percentage change, divide by the **old** rate.
- **Diagrams**: label the axes "price of [currency] in [other currency]" and "quantity of [currency]", label D and S and the old and new equilibrium rates.
- **Multiple choice**: decide first whether the currency rose or fell, and whether the event shifts demand or supply; watch for "definitely", "directly" and "immediate".

Quick check

1. The exchange rate changes from $\text{£1} = \$1.25$ to $\text{£1} = \$1.40$. (a) Has the pound appreciated or depreciated? (b) A car made in the UK costs £20 000. Calculate its price in US dollars before and after the change.
2. For each event, say whether it shifts the demand for or the supply of the country's currency, which way, and whether the currency appreciates or depreciates: (i) more foreign tourists visit the country; (ii) the central bank cuts the interest rate; (iii) firms in the country buy more foreign machinery; (iv) a foreign MNC builds a factory in the country.
3. A country fixes its currency at \$0.80. At this rate, 30 million units are supplied and 22 million demanded. What must the central bank do to hold the rate, and how many dollars of reserves will it use?
4. Identify **two** disadvantages of a floating exchange rate. **[2]**
5. Foreign demand for a country's exports has a PED of -0.4 . A depreciation lowers the foreign-currency price of its exports by 10%. Calculate the percentage change in export revenue measured in foreign currency.

Answers

1. (a) Each pound now buys more dollars, so the pound has **appreciated**. (b) Before: $20\,000 \times 1.25 = 25\,000$, so **\$25 000**; after: $20\,000 \times 1.40 = 28\,000$, so **\$28 000**.
2. (i) Demand rises (right): appreciates. (ii) Demand falls (left) as hot money leaves, and supply rises as savers move money abroad: depreciates. (iii) Supply rises (right) to pay for the imports: depreciates. (iv) Demand rises (right) as the MNC buys the currency to pay for the factory: appreciates.
3. There is an excess supply of $30 - 22 = 8$ million units, so the central bank must **buy** 8 million units of its currency, paying $8 \times 0.80 = 6.4$, that is **\$6.4 million** of reserves (or raise interest rates to raise demand).
4. Uncertainty for firms about the price of imports and export earnings (1). Speculation can cause large swings in the rate (1). (Also: less foreign investment.)
5. Quantity rises by $0.4 \times 10 = 4\%$. Revenue in foreign currency changes by $0.90 \times 1.04 = 0.936$, a **fall of 6.4%**: demand is inelastic, so export revenue in foreign currency falls.

Past questions to try

- 0455/22/F/M/22 Q2: part (c), how a fall in the exchange rate could reduce a current account deficit.
- 0455/22/O/N/22 Q5: part (c), how a fall in the exchange rate could increase inflation.
- 0455/21/O/N/22 Q3: part (d), whether a country benefits from a fixed exchange rate.
- 0455/22/M/J/23 Q4: part (b), two causes of a rise in a floating exchange rate.